Supreme Court, U. S.
FILED
MAR 20 1980
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1979

~~79~~ 1470

No. _____

LEHMAN BROTHERS INCORPORATED,

Petitioner,

v.

LEO and LOYCE LILLY; and THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

JAMES J. HAGAN
Counsel for Petitioner
One Battery Park Plaza
New York, New York 10004
(212) 483-9000

Of Counsel:
NANCY F. MCKENNA
MARGARET V. SACHS
SIMPSON THACHER & BARTLETT

March 20, 1980

TABLE OF CONTENTS

	PAGE
Opinions Below	2
Jurisdiction	2
Questions Presented	2
Statute and Rule Involved	3
Statement of the Case	4
Reasons for Granting the Writ:	
Point I—The decision below conflicts with the decisions of this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), *S. D. Cohn & Co.* v. *Woolf*, 426 U.S. 944 (1976), and *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977)	8
Point II—The Court of Appeals erred in failing to recognize the importance of insider reactions in resolving the issue of materiality under rule 10b-5	12
Conclusion	15
Appendix	
Opinion of the District Court	1a
Opinion of the Court of Appeals	14a
Judgment of the Court of Appeals	33a
Orders of the Court of Appeals Denying Petitions for Rehearing	35a

TABLE OF AUTHORITIES

PAGE

Cases:

Alabama Farm Bureau Mutual Casualty Co. v. American Fidelity Life Insurance Co., 606 F.2d 602 (5th Cir. 1979) 9

Brascan, Ltd. v. Edper Equities, Ltd., 477 F. Supp. 773 (S.D.N.Y. 1979) 10

Chelsea Associates v. Rapanos, 527 F.2d 1266 (6th Cir. 1975) 12
Chris-Craft Industries, Inc. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970) 11

Dasho v. Susquehanna Corp., 461 F.2d 11 (7th Cir.), *cert. denied,* 408 U.S. 925 (1972) 11

Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) 13, 14
Fridrich v. Bradford, [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,723 (M.D. Tenn. 1974), *rev'd on other grounds,* 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977) 11

Galfand v. Chestnutt, 402 F. Supp. 1318 (S.D.N.Y. 1975), *aff'd and modified on other grounds,* 545 F.2d 807 (2d Cir. 1976) 13
General Time Corp. v. Talley Industries, Inc., 403 F.2d 159 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969) 13, 14
Gold v. DCL, Inc., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,036 (S.D.N.Y. 1973) 13, 14
Goldberg v. Meridor, 567 F.2d 209 (2d Cir. 1977), *cert. denied,* 434 U.S. 1069 (1978) 9

Harkavy v. Apparel Industries, Inc., 571 F.2d 737 (2d Cir. 1978) 9

PAGE

Hassig v. Pearson, 565 F.2d 644 (10th Cir. 1977) 10
Holmes v. Bateson, 583 F.2d 542 (1st Cir. 1978) 9

In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation, 467 F. Supp. 227 (W.D. Tex. 1979) 10
International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979) 14

Joyce v. Joyce Beverages, Inc., 571 F.2d 703 (2d Cir.), *cert. denied,* 437 U.S. 905 (1978) 9

Kidwell *ex rel.* Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979) 9
Kin-Ark Corp. v. Boyles, 593 F.2d 361 (10th Cir. 1979) 9

List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965) 13, 14

Meyers v. Moody, 475 F. Supp. 232 (N.D. Tex. 1979) 10
Mittendorf v. J. R. Williston & Beane, Inc., 372 F. Supp. 821 (S.D.N.Y. 1974) 13

S. D. Cohn & Co. v. Woolf, 426 U.S. 944 (1976) 2, 8–10, 12
St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 562 F.2d 1040 (8th Cir. 1977), *cert. denied,* 435 U.S. 925 (1978) 10
Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 2, 8–10, 12
SEC v. Bausch & Lomb, Inc., 565 F.2d 8 (2d Cir. 1977) 10–12
SEC v. Blatt, 583 F.2d 1325 (5th Cir. 1978) 9
SEC v. Geon Industries, Inc., 381 F. Supp. 1063 (S.D.N.Y. 1974), *rev'd in part on other grounds,* 531 F.2d 39 (2d Cir. 1976) 13

PAGE

SEC v. Koracorp Industries, Inc., 575 F.2d 692 (9th Cir.), *cert. denied*, 439 U.S. 953 (1978) 9
SEC v. Lum's, Inc., 365 F. Supp. 1046 (S.D.N.Y. 1973) 13
SEC v. Parklane Hosiery Co., 558 F.2d 1083 (2d Cir. 1977) 12
SEC v. Shapiro, 494 F.2d 1301 (2d Cir. 1974) 13, 14
SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969) 11–13
Shofstall v. Allied Van Lines, Inc., 455 F. Supp. 351 (N.D. Ill. 1978) 10
Spielman v. General Host Corp., 402 F. Supp. 190 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976) 13
Sundstrand Corp. v. Sun Chemical Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977) 10

Thomas v. Duralite Co., 524 F.2d 577 (3d Cir. 1975) 13, 14
TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) 2, 5–13

Walsh v. Butcher & Sherrerd, 452 F. Supp. 80 (E.D. Pa. 1978) 10
Woolf v. S. D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975), *vacated*, 426 U.S. 944 (1976), *on remand*, 546 F.2d 1252 (5th Cir.), *cert. denied*, 434 U.S. 831 (1977) 9
Wright v. Heizer Corp., 560 F.2d 236 (7th Cir. 1977), *cert. denied*, 434 U.S. 1066 (1978) 10

Zweig v. Hearst Corp., 594 F.2d 1261 (9th Cir. 1979) 9

Statutes and Rules:

Fed. R. Civ. P. 50(a) 5
17 C.F.R. § 240.10b-5 ..... 2–4, 8–10, 12, 14
17 C.F.R. § 240.14a-9 8
15 U.S.C. § 78j(b) 2–4, 8
15 U.S.C. § 78n(a) 8, 12

IN THE

Supreme Court of the United States

October Term, 1979

No.

LEHMAN BROTHERS INCORPORATED,

Petitioner,

v.

LEO and LOYCE LILLY; and THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Lehman Brothers Incorporated ("Lehman") petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit entered on October 5, 1979 and the order of that court entered on December 21, 1979 denying Lehman's petition for rehearing in banc. The court below reversed the order of the United States District Court for the Southern District of New York, which had dismissed the complaint against Lehman and the other defendant, the State Teachers Retirement System of Ohio Pension Fund ("the Fund").

Opinions Below

The opinion of the Court of Appeals, rendered October 5, 1979, is reported at 608 F. 2d 55 (14a[1]); the opinion of the District Court, which was reversed by the Court of Appeals, is reported at [1979 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 96,769 (1a).

Jurisdiction

The judgment of the Court of Appeals was entered on October 5, 1979 (33a), and a timely petition for rehearing filed by the petitioner herein was denied by the Court of Appeals on December 21, 1979 (35a). This petition was filed within 90 days of that date. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

Questions Presented

1. This Court's decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), amplified in *S. D. Cohn & Co.* v. *Woolf*, 426 U.S. 944 (1976), and *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977), established the standard for resolving the issue of materiality under § 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. Does not the standard of materiality applied by the court below conflict so sharply with those decisions as to require the interposition of this Court?

2. Did the Court of Appeals err in failing to recognize the importance of insider reactions in resolving the issue of materiality under rule 10b-5?

1. Citations with the suffix "a" are to the Appendix hereto.

Statute and Rule Involved

Section 10(b) of the Securities Exchange Act of 1934 provides in pertinent part that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

15 U.S.C. § 78j(b).

Rule 10b-5, promulgated thereunder, provides that:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a

fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5.

Statement of the Case

Lehman, an investment banking firm and broker-dealer headquartered in New York City, was named as a defendant in an action brought on July 1, 1975 in the Southern District of New York to recover damages for an alleged violation of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder. Plaintiffs are the class representatives of all persons who purchased from the Fund any of the 80,000 shares of common stock of a real estate investment trust ("REIT") called Guardian Mortgage Investors ("Guardian") sold in a secondary distribution through Lehman on or about March 20, 1974.[2]

The action was tried to the District Court, Hon. Charles S. Haight, Jr., and a jury in January, 1979. The theory which plaintiffs advanced at trial was that prior to March 20, 1974, Lehman had been advised by Guardian of certain allegedly material inside information regarding the level of Guardian's problem loans. Lehman was alleged in turn to have disclosed that information to the Fund, which on March 20 sold 80,000 shares of Guardian

2. The Fund was also named a defendant, as were Guardian and Charter Advisory Company ("Charter"), Guardian's investment advisor. Plaintiffs stipulated to the dismissal of the case against Guardian and Charter on May 31, 1977, prior to trial. The action proceeded to trial with respect to Lehman and the Fund and at the conclusion of plaintiffs' case, the complaint was dismissed as to both defendants. The Fund has also filed a certiorari petition in this Court.

stock to plaintiffs and their class through a secondary distribution handled by Lehman.[3]

The allegedly material information regarding an increase in Guardian's problem loans had been reflected in two memoranda prepared by a Lehman securities analyst after telephone conversations with Guardian management. In each memorandum, the analyst noted that problem loans were running about 4% of fundings, but concluded, on the basis of his discussions with management, that none represented a potential loss of principal. Both memoranda accordingly predicted that Guardian's quarterly dividend would remain unchanged. (Plaintiffs' Trial Exhibits 14 and 21).

At the conclusion of plaintiffs' case, both defendants moved for a directed verdict in their favor, Fed.R.Civ.P. 50(a). The District Court granted these motions in an order entered February 1, 1979, which held that information regarding the level of problem loans in the factual context of this case was not material as a matter of law. (1a). In reaching this conclusion, the District Court applied the standard of materiality propounded by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) (*"TSC Industries"*) (12a n.12). In accordance with *TSC Industries*, the District Court considered whether the problem loan information would have been

3. In their pleadings and trial memorandum, plaintiffs had advanced a different theory, namely, that the information allegedly transmitted by Lehman had concerned not the level of Guardian's problem loans, but instead sharp increases in its loan loss reserves (2a-3a), which would directly impact its earnings. The District Court found that this theory was without any support in the record at trial (5a), and this finding was not challenged on appeal. (Brief for Appellant at 26).

"viewed by a reasonable investor as 'having significantly altered the total mix of information made available,'" *see* 426 U.S. at 449, and concluded that it would not. (12a). As evidence for its conclusion, the court pointed not only to the heavy publicity given to deteriorating economic conditions in the REIT industry, but also to the predictions made by Lehman in its two memoranda, notwithstanding its knowledge of the level of Guardian's problem loans, that Guardian's quarterly dividend would remain unchanged. (10a-12a). Accordingly, the District Court dismissed the complaint against both defendants. Plaintiffs appealed.

The Court of Appeals, in an opinion by District Judge Sifton of the Eastern District of New York, sitting by designation (14a), held that the District Court's finding of non-materiality was error. The court's holding resulted from the application of a standard of materiality different from that applied by the District Court and utterly inconsistent with the standard propounded by this Court in *TSC Industries.* While the Court of Appeals did not leave the *TSC Industries* standard unmentioned (20a), it proceeded to reformulate it in the following manner:

> The reasonable investor has an interest in knowing not only information which will, with reasonable certainty, affect the price of the stock he contemplates buying or selling. He also has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty and turns an otherwise reasonable investment into a speculative one.

(24a).

The approach to materiality taken by the court below stands out not only because of its unwarranted departure from *TSC Industries,* but also because of its neglect of a time-honored index of materiality—the reactions of insiders. The Court of Appeals criticized the District Court for the attention it had paid to Lehman's assessment of the problem loan information, stating:

> A further difficulty presented by the trial court's reasoning is that it analyzes the significance of the information alleged to have been tipped not from the standpoint of the reasonable investor at all, but rather from the standpoint of the tippee, focusing on the significance attributed to the information by its recipient. There is no basis for such an approach in our cases.

(24a).

Lehman filed a timely petition for rehearing, in which it took exception to the Court of Appeals' application of a standard of materiality different from that propounded by this Court, as well as to the Court of Appeals' failure to recognize the importance of insider reactions in resolving the issue of materiality. [Petition of Lehman Brothers Incorporated for Rehearing and Suggestion for In Banc Consideration (October 19, 1979)]. The petition was denied (35a).[4]

4. A petition for rehearing, including the suggestion that the case be heard in banc, was also filed by the Fund, and was likewise denied. (36a).

Reasons for Granting the Writ

POINT I

The decision below conflicts with the decisions of this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976), *S. D. Cohn & Co.* v. *Woolf*, 426 U.S. 944 (1976), and *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977).

This Court in *TSC Industries* propounded the standard by which the issue of materiality is to be resolved. After rejecting the standard espoused by the United States Court of Appeals for the Seventh Circuit that material facts include " 'all facts which a reasonable shareholder *might* consider important' "[5] this Court held that the true test of materiality requires:

> a showing of a substantial likelihood that, under all the circumstances, the omitted fact *would have assumed actual significance in the deliberations of the reasonable shareholder.* Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Id. at 449 (emphasis supplied).

While the *TSC Industries* standard was propounded in the context of the Securities Exchange Act's § 14(a), 15 U.S.C. § 78n(a) and rule 14a-9, 17 C.F.R. § 240.14a-9, thereunder, it applies equally to actions brought under § 10(b) and rule 10b-5, as this Court made plain in *S. D. Cohn &*

5. *TSC Industries* at 445 (emphasis the Court's).

Co. v. *Woolf, supra* ("*Cohn*") and *Santa Fe Industries, Inc.* v. *Green, supra* ("*Santa Fe*"). In *Cohn,* this Court remanded for consideration in light of *TSC Industries* a decision of the United States Court of Appeals for the Fifth Circuit that had propounded a standard of materiality for rule 10b-5 which differed from the standard of *TSC Industries. See* 426 U.S. at 944.[6] In *Santa Fe,* this Court cited *TSC Industries* as its sole authority for holding an omission not material under rule 10b-5. *See* 430 U.S. at 474 n.14.

In accordance with the clear teachings of *TSC Industries, Cohn,* and *Santa Fe,* numerous circuit court decisions have applied the standard of *TSC Industries* in resolving the issue of materiality under rule 10b-5. *See Alabama Farm Bureau Mutual Casualty Co.* v. *American Fidelity Life Insurance Co.,* 606 F.2d 602, 611 (5th Cir. 1979); *Kidwell ex rel. Penfold* v. *Meikle,* 597 F.2d 1273, 1293 (9th Cir. 1979); *Zweig* v. *Hearst Corp.,* 594 F.2d 1261, 1266 (9th Cir. 1979); *Kin-Ark Corp.* v. *Boyles,* 593 F.2d 361, 367 (10th Cir. 1979); *SEC* v. *Blatt,* 583 F.2d 1325, 1330 (5th Cir. 1978); *Holmes* v. *Bateson,* 583 F.2d 542, 557-58 (1st Cir. 1978); *SEC* v. *Koracorp Industries, Inc.,* 575 F.2d 692, 701 (9th Cir.), *cert. denied,* 439 U.S. 953 (1978); *Joyce* v. *Joyce Beverages, Inc.,* 571 F.2d 703, 706-07 n.6 (2d Cir.), *cert. denied,* 437 U.S. 905 (1978); *Harkavy* v. *Apparel Industries, Inc.,* 571 F.2d 737, 740-41 (2d Cir. 1978); *Goldberg* v. *Meridor,* 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied,* 434 U.S.

6. The Fifth Circuit had stated that rule 10b-5 requires a showing that omissions were "such that a reasonable investor . . . *might* have considered them important in the making of his investment decision." *See Woolf* v. *S. D. Cohn & Co.,* 515 F.2d 591, 614 (5th Cir. 1975), *vacated,* 426 U.S. 944 (1976), *on remand,* 546 F.2d 1252 (5th Cir.), *cert. denied,* 434 U.S. 831 (1977) (emphasis supplied).

1069 (1978); *Hassig* v. *Pearson,* 565 F.2d 644, 649-50 (10th Cir. 1977); *SEC* v. *Bausch & Lomb, Inc.,* 565 F.2d 8, 15 (2d Cir. 1977); *St. Louis Union Trust Co.* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 562 F.2d 1040, 1048 (8th Cir. 1977), *cert. denied,* 435 U.S. 925 (1978); *Wright* v. *Heizer Corp.,* 560 F.2d 236, 248 (7th Cir. 1977), *cert. denied,* 434 U.S. 1066 (1978); *Sundstrand Corp.* v. *Sun Chemical Corp.,* 553 F.2d 1033, 1040 (7th Cir.), *cert. denied,* 434 U.S. 875 (1977). *See also Brascan, Ltd.* v. *Edper Equities, Ltd.,* 477 F. Supp. 773, 787 (S.D.N.Y. 1979); *Meyers* v. *Moody,* 475 F. Supp. 232, 244 (N.D. Tex. 1979); *In re Commonwealth Oil/Tesoro Petroleum Corp. Securities Litigation,* 467 F. Supp. 227, 256 (W.D. Tex. 1979); *Shofstall* v. *Allied Van Lines, Inc.,* 455 F. Supp. 351, 355 n.3 (N.D. Ill. 1978); *Walsh* v. *Butcher & Sherrerd,* 452 F. Supp. 80, 83 (E.D. Pa. 1978).

Thus, by its decisions in *TSC Industries, Cohn,* and *Santa Fe,* this Court has made it overwhelmingly clear that materiality under rule 10b-5 requires a "substantial likelihood that . . . the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder . . . [or] a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See* 426 U.S. at 449.

The contrast between this standard and the standard espoused by the court below is patent. The standard of the Court of Appeals does not focus on the *importance* a piece of information *would* have had to a reasonable investor. On the contrary, the standard announced by the court below, which speaks in terms of information making it "impossible [for the investor] to assess the value of his

investment with any reasonable certainty" (24a), throws into the ambit of mandatory disclosure vast amounts of information of merely debatable import which in the context of "the 'total mix' of information . . . available" have no significance whatever. The standard of the Court of Appeals therefore represents a significant lowering of the standard propounded by this Court.

The clash between the *TSC Industries* standard and the new standard espoused by the court below has yet another aspect. The new standard focuses on the intrinsically non-objective criterion of the transformation of an investment from "reasonable" to "speculative" and on the equally non-objective criterion of the impact on the investment's "value," as compared with its market value. The use of criteria which defy objective measurement flies in the face of this Court's holding in *TSC Industries* that the question of materiality is objective in nature. *See id.* at 445. In addition, the criterion of impact on "value" rather than market value utterly ignores a principle well-settled in the Courts of Appeal that substantial impact on market value is an essential requirement of materiality. *See SEC* v. *Bausch & Lomb, Inc., supra,* 565 F.2d at 14-15; *Dasho* v. *Susquehanna Corp.,* 461 F.2d 11, 32 n.49 (7th Cir.), *cert. denied,* 408 U.S. 925 (1972) (Stevens, J.); *Chris-Craft Industries, Inc.* v. *Bangor Punta Corp.,* 426 F.2d 569, 581-82 (2d Cir. 1970) (Lumbard, C. J., dissenting); *SEC* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969). *See also Fridrich* v. *Bradford,* [1974-75 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,723 at 96,404 (M.D. Tenn. 1974), *rev'd on other grounds,* 542 F.2d 307 (6th Cir. 1976), *cert. denied,* 429 U.S. 1053 (1977).

The decision of the court below thus effectively emasculates this Court's decisions in *TSC Industries, Cohn,* and *Santa Fe* and raises the spectre that the alleged omissions of this defendant and defendants in other rule 10b-5 actions will be subject to a standard of materiality lower than that applied in § 14(a) actions, which normally involve carefully prepared proxy statements. This Court should grant certiorari to decide whether that decision, and the unjust and anomalous consequences thereof, should be allowed to stand.

POINT II

The Court of Appeals erred in failing to recognize the importance of insider reactions in resolving the issue of materiality under rule 10b-5.

The Court of Appeals took the position that, in resolving the issue of materiality, the significance attributed to the information by insiders is not important, notwithstanding a lack of authority for this position from any Circuit or this Court. The Court of Appeals' criticism of the District Court for giving weight to Lehman's view of the significance of Guardian's problem loans completely disregards the unbroken line of decisions attesting to the importance of insider reactions to questions of materiality. *See SEC* v. *Bausch & Lomb, Inc., supra,* 565 F.2d at 18 ("major index of materiality"); *SEC* v. *Parklane Hosiery Co.,* 558 F.2d 1083, 1089 (2d Cir. 1977) ("[i]mportant evidence for evaluating" materiality); *Chelsea Associates* v. *Rapanos,* 527 F.2d 1266, 1270 (6th Cir. 1975) ("highly persuasive evidence of materiality"); *SEC* v. *Texas Gulf Sul-*

phur Co., supra, 401 F.2d at 851 ("major factor" and "highly pertinent evidence and the only truly objective evidence of . . . materiality"); *Galfand* v. *Chestnutt,* 402 F. Supp. 1318, 1331 (S.D.N.Y. 1975), *aff'd and modified on other grounds,* 545 F.2d 807 (2d Cir. 1976) (" 'major factor' "); *Spielman* v. *General Host Corp.,* 402 F. Supp. 190, 204 (S.D.N.Y. 1975), *aff'd,* 538 F.2d 39 (2d Cir. 1976) (" 'the only truly objective evidence of . . . materiality' "); *SEC* v. *Geon Industries, Inc.,* 381 F. Supp. 1063, 1068 (S.D.N.Y. 1974), *rev'd in part on other grounds,* 531 F.2d 39 (2d Cir. 1976) (" 'highly pertinent' " and " 'the only truly objective evidence of . . . materiality' "); *Mittendorf* v. *J. R. Williston & Beane, Inc.,* 372 F. Supp. 821, 828 (S.D.N.Y. 1974) (" 'major factor' "); *Feit* v. *Leasco Data Processing Equipment Corp.,* 332 F. Supp. 544, 574 (E.D. N.Y. 1971) ("significant, possibly determinative, insight into the question of materiality"). *See also Thomas* v. *Duralite Co.,* 524 F.2d 577, 585 (3d Cir. 1975); *SEC* v. *Shapiro,* 494 F.2d 1301, 1307 (2d Cir. 1974); *General Time Corp.* v. *Talley Industries, Inc.,* 403 F.2d 159, 162 (2d Cir. 1968), *cert. denied,* 393 U.S. 1026 (1969); *List* v. *Fashion Park, Inc.,* 340 F.2d 457, 464 (2d Cir.), *cert. denied,* 382 U.S. 811 (1965); *SEC* v. *Lum's, Inc.,* 365 F. Supp. 1046, 1060 (S.D.N.Y. 1973); *Gold* v. *DCL, Inc.,* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,036 at 94,169 n.13 (S.D.N.Y. 1973).

Inattention to insider reactions carries substantial consequences. Such inattention undermines this Court's directive in *TSC Industries* that resolution of the materiality issue be based on "delicate assessments." *See id.* at 450. In order to make these delicate assessments, there must be

a broad evidentiary base, which would be narrowed considerably by the setting aside of insider reactions, a category which encompasses a wide variety of evidence. *See, e.g., Thomas* v. *Duralite Co., supra,* 524 F.2d at 585 (insiders' postponement of negotiations); *SEC* v. *Shapiro, supra,* 494 F.2d at 1307 (insiders' purchase of stock just after receipt of information); *General Time Corp.* v. *Talley Industries, Inc., supra,* 403 F.2d at 162 (insider's failure to correct omissions); *List* v. *Fashion Park, Inc., supra,* 340 F.2d at 464 (insider's resale of stock at low price); *SEC* v. *Lum's, Inc., supra,* 365 F. Supp. at 1060 (insider's announcement of information at meeting); *Gold* v. *DCL, Inc., supra,* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,036 at 94,169 n.13 (insider's strong opposition to release of information); *Feit* v. *Leasco Data Processing Equipment Corp., supra,* 332 F. Supp. at 574 (insider's previous publication of comparable information).

A further consequence of neglecting insider reactions is the impact on the fairness of the adjudication. As this Court has recently acknowledged, rule 10b-5 does not identify with specificity what information must be disclosed. *See International Brotherhood of Teamsters* v. *Daniel,* 439 U.S. 551, 569 (1979). To avoid extending this non-specific disclosure obligation beyond its reasonable and intended scope, the materiality of the information not disclosed must be evaluated in light of all available evidence, including insider reactions.

The importance to be attached to insider reactions has considerable significance for rule 10b-5 litigation and is an

issue which will recur in numerous cases to which this Court will be unable to give separate attention. The issue thus calls for this Court's intervention by writ of certiorari.

Conclusion

For the reasons set forth above, the petition for a writ of certiorari should be granted and the judgment of the Court of Appeals for the Second Circuit reversed.

Respectfully submitted,

JAMES J. HAGAN
Counsel for Petitioner
One Battery Park Plaza
New York, New York 10004
(212) 483-9000

Of Counsel:
NANCY F. MCKENNA
MARGARET V. SACHS
SIMPSON THACHER & BARTLETT

March 20, 1980

APPENDIX

Opinion of the District Court

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

75 Civil 3230

LEO and LOYCE LILLY,

Plaintiffs,

against

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND and LEHMAN BROTHERS INCORPORATED,

Defendants.

HAIGHT, District Judge: Defendants move at the conclusion of plaintiffs' evidence, in this jury trial alleging securities laws violations, for a directed verdict in their favor. For the reasons stated, the motions are granted.

I.

This is a class action commenced by the named plaintiffs on behalf of all persons who were purchasers from defendant State Teachers Retirement System of Ohio Pension Fund of any of the 80,000 shares of Guardian Mortgage Investors common stock, sold by the Pension Fund in a secondary distribution through defendant Lehman Brothers Inc. on or about March 20, 1974. Plaintiffs claim violations of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

The complaint was filed on July 1, 1975. Its allegations of wrongdoing are precise. ¶11 alleges that sometime in the month of February, 1974, Peat Marwick & Mitchell as outside accountants for Guardian, began discussions with officers of Guardian and Charter Advisory Company, its investment advisor, "with reference to increasing the allowance for loan losses," taking the position that "an increase would be required." ¶12 alleges that on or about February 8, 1974, the audit committee of Guardian's trustees reviewed a draft of the 1974 financials, "at which time there was a discussion of reserves for loan losses." ¶13 alleges that on or about March 14, 1974, at a meeting of the executive committee of the trustees, a report was received that Peat, Marwick "had persisted in requiring an increase in loan loss reserves, and had also raised questions respecting loans on which interest had ceased to accrue." ¶14 alleges that Guardian and Charter officers resisted Peat, Marwick's position "that an increase in the allowance for loan losses would be required." ¶15 alleges that after "intense discussions" officers of Guardian and Charter "agreed to an increase in the allowance for loan losses." ¶16 alleges that Lehman knew of "reduced Guardian earnings" and the nature and direction of Peat, Marwick's discussions "concerning the increased allowance for loan losses," and passed on this non-public information to Ohio Teachers, which thereafter made the secondary distribution of 80,000 Guardian shares through Lehman. And ¶¶17 and 18 allege that, following Guardian's public disclosure on March 29, 1974 (nine days after the sale) of a special addition to the allowance for possible loan losses in the amount of $875,000, and a cut in its quarterly dividend to $.74 from $1.02, the value of Guardian's shares substantially declined.

Pre-trial discovery has not led to any further allegations of wrongdoing. The complaint has not been amended. Plaintiffs' theory of recovery remains the same. It is summarized in plaintiffs' trial memorandum at p. 2:

> "Briefly stated, this is a Rule 10b-5 claim based on the allegation that Ohio sold 80,000 GMI shares to the public through Lehman on a secondary distribution at 27¼ per share on March 20, 1974 while possessing non-public inside information that GMI's accountants Peat, Marwick, Mitchell & Company ('Peat, Marwick') were conducting a tough audit and that GMI knew of the probability of an increase to the reserve for loan losses which would necessarily decrease the earnings and the dividend."

And again at p. 3:

> "Plaintiffs' theory of the case is that Ohio's sale of its 80,000 GMI shares on the Secondary throguh [sic] Lehman, occurred after Lehman learned from GMI of a likely addition to GMI's loan loss reserve that would materially affect GMI's earnings and year end dividend."

And again at p. 4:

> "The issue is not whether the specific $875,000 figure was leaked, but whether persons at Lehman learned of the auditors taking a hard look at known problem loans made by GMI and the probable result and misused that information."

And again at pp. 5-6:

> ". . . if Lehman knew of the difficulties being encountered on the audit and the probability of its outcome, it could not transmit it to Ohio or otherwise use it in connection with the sale or encourage the sale by Ohio to impress Ohio for future business purposes."

Defendants move at the conclusion of plaintiffs' case, pursuant to Rule 50(a), F.R.Civ.P., for a directed verdict in their favor. The principles pertinent to the motion are familiar. Plaintiffs are entitled to have the Court view the evidence in the light most favorable to them. If, upon such view, an actual issue of fact is posed by evidence of substance, it must be resolved by the jury. It is not the Court's proper function, on a Rule 50(a) motion, to weigh the credibility of witnesses or otherwise consider the weight of the evidence. On the other hand, defendants are entitled to an evaluation by the Court of all the evidence adduced by plaintiffs, in order to determine whether the purported fact issue is actual rather than theoretical, real rather than imaginary; or whether plaintiffs' proof attains the dignity of substantial evidence, and is not such as merely to create suspicion, or grounds for conjecture or speculation. Jurors may not speculate or conjecture. They must not traffic in suspicion, but resolve actual disputes arising from the evidence. Where, measured by these standards, the evidence is such that reasonable men can reach only one conclusion, it is insufficient to state a case for the jury.[1]

Plaintiffs argue correctly, at p. 6 of their trial memorandum, that they may "prove liability by circumstantial evidence in the form of documents and testimony supplied by defendants or persons associated with them." They say further, and I accept, that "plaintiff may rely on such [evidence] and need not provide direct evidence of disclosure by the tipper to the tippee." However, in order

1. See generally *Miller v. New York Produce Exchange,* 550 F.2d 762, 767 (2d Cir. 1977); *Radiation Dynamics v. Goldmuntz,* 464 F.2d 876, 885-6 (2d Cir. 1972).

to determine, in response to defendants' motion, whether or not the proffered issues of fact are genuine, the Court must perforce consider not only the circumstantial evidence upon which plaintiffs rely, but also the direct evidence which, by live or deposition testimony, they adduced as part of their case.

Measured by these standards, it is immediately apparent that there is a total absence of proof of the particular theory upon which plaintiffs sent the case to trial. That theory, it may be recalled, was that prior to sale on March 20, Lehman was made aware of the substance, direction, and likely result of Peat, Marwick's "tough audit" discussions with Guardian in respect of an increased loan loss reserve; and that Lehman communicated that inside information to the Pension Fund. I have the gravest doubt, in the face of the specific denials of a Guardian officer, that the jury could find the Peat, Marwick/Guardian dialogue had advanced to that stage prior to March 25, five days after the sale.[2] But assuming *arguendo* that this finding would be permissible in law, there is not a scintilla of evidence that such information was communicated to Lehman, let alone from Lehman to the Pension Fund, prior to the sale. In essence, plaintiffs' argument is that notwithstanding the specific denials of the witnesses with knowledge of the facts, it must have happened otherwise. Such arguments, if allowed, would lead jurors into the

2. Guardian's senior vice president testified that Peat, Marwick did not reveal to Guardian its unexpected and unwelcome computations, requiring an increase in the loan loss reserve, until March 25. Wisker, Tr. 254-257, 296-297, 302. Plaintiffs adduced no contrary evidence from other Guardian or Charter officers, or from Peat, Marwick.

trackless quicksand of speculation.[3] That cannot be countenanced. Plaintiffs are not entitled to go to the jury, as to either defendant, on the precise theory alleged in the complaint.

II.

Plaintiffs argue, however, that the trial record contains evidence sufficient to permit a jury finding of a 10-b (5) violation, within the broader boundaries of the complaint. In particular, it is said that Lehman acquired pre-sale knowledge of an increase in Guardian's "problem loans" which taints the Pension Fund sale in suit.

Viewing the evidence in the light most favorable to plaintiffs, I conclude that the jury could reasonably find the following facts:

1. On March 1, 1974, Denis Callaghan, a securities analyst with Lehman, spoke by telephone to Patrick Ahern, the president of Guardian. Callaghan was given information by Ahern which Callaghan summarized in an internal Lehman memorandum dated March 1 (PX 21). Ahern stated that Guardian "currently has a default ratio of 4 per cent, or approximately $16 million in problem loans, as compared to the $12 million amount the trust has been carrying for the past 4-5 months." Callaghan discussed the "problem loans" further with Ahern, and

3. No witness from Guardian or Lehman gave any testimony tending to show that Guardian told Lehman about the progress of the Peat, Marwick audit and its attendant dialogue. Plaintiffs' argument is that, notwithstanding this total absence of proof, the jury could have inferred from Lehman's relationship to Guardian as financial advisor that Lehman had such knowledge. But proof of actual knowledge is required in cases of this nature; it is not furnished by "should have suspected" or "must have known" theories. *Miller, supra,* at 766; cf. *Dyer v. MacDougall,* 201 F.2d 265 (2d Cir. 1952).

formed the belief, as expressed in the March 1 memorandum, "that none of these investments represents any potential loss of principal." Callaghan also stated in the March 1 memo that "we expect this quarter's dividend to be about the same as last quarter's $1.08." Callaghan concluded his March 1 memorandum with the observation that: "It would not totally surprise us if the trust [Guardian] were to strengthen the reserve over the next few quarters and report earnings and dividends a little lower than our estimate."

In connection with this finding, the jury would also be bound to find, on the basis of contradicted direct evidence, that the economic conditions affecting real estate investment trusts, or "REITs," in the early months of 1974[4] prompted similar inquiries from many securities analysts;[5] and that the information Ahern gave to Callaghan did not

4. The evidence adduced during plaintiffs' case demonstrates conclusively that economic conditions adversely affecting the real estate and construction industries worked to the severe prejudice of REITs such as Guardian, which borrowed money from banks and commercial lenders and loaned it to real estate and construction entrepreneurs, realizing their profits from the differential in interest rates. The REIT industry began to encounter difficulty during the first three months of 1974. The Wall Street Journal of January 21, 1974 contained a long analytical article (DX E) captioned "REITs Face Shake-Out As Investments Sour, Cash Sources Dry Up—The Investment Concerns Say Building Firms' Troubles Cause Defaults on Loans"—and, prophetically in the context of the case at bar—"Auditors Take a Closer Look."

5. The economic conditions summarized in the preceding footnote understandably caused securities analysts to bombard REIT managements with inquiries. Ahern, Guardian's president, testified:

> "Problem loans is a designation that began around that time. But at the time beginning around then and in subsequent months, problem loans became the heavy focus with everyone in the securities industry in analyzing the financial condition of a REIT, and problem loans became a normal part of any conversation that you have." Tr. 343.

differ from the information he gave to other analysts who made comparable inquiries.[6]

2. On March 13, Callaghan spoke by telephone with Howard Wisker, an officer of Guardian, who in essence reiterated the information given by Ahern on March 1. Callaghan reported on his March 13 conversation with Wisker in a report dated March 14 sent to Lehman customers (PX 14). Wisker said the "problem loans" were running "about 4 percent of fundings," the same percentage referred to by Ahern on March 1; the dollar amount of problem loans was stated by Wisker to be "$16-18 million." Wisker stated that: "Management does not anticipate any loss of principal on existing problem loans." Wisker declined to comment on expected earnings.[7] On the basis of this information, Callaghan again estimated, as he had

6. Ahern testified, with respect to his telephone conversation at the beginning of March with Callaghan, that the questions Callaghan put:

> ". . . were not unusual questions. They were normal questions that not only he but a number of the other analysts would ask." Tr. 341.

Plaintiffs argued on the motion that there was no specific evidence of Ahern giving comparable information to other, named analysts. That is of no significance, in view of Ahern's understandable inability, long after the events, to remember any particular telephone call with specificity—including Callaghan's. In sum, the only evidence on the point is that at this period of time Ahern received comparable inquiries from a number of securities analysts, including Callaghan, and gave the same information to all of them.

7. As in the case of the Callaghan/Ahern telephone conversation, fn. 6 *ante*, the evidence shows beyond peradventure that Wisker's call from Callaghan on March 13 was one of many he received from analysts during this period, and that he gave Callaghan the same information (and declined the same information, such as a prediction of earnings) as he did the others. Tr. 269-275, 312-314. Equally, Wisker's failure to recall specifically any particular telephone call at this time is not significant.

done on March 1, that "the dividend should remain at $1.08," the level achieved during the prior quarter.

3. The Lehman broker in charge of the Pension Fund account was Martin Shafiroff. Shafiroff was cognizant of the contents of the Callaghan reports of March 1 and 14 when, on March 18, he initiated a conference telephone call to Herschel Pittenger and John Gunthorp, who were in charge of the Pension Fund portfolio.

4. In that conference call, Shafiroff and Callaghan described to Pension Fund representatives current adverse conditions in the REIT industry, and made specific references to Great American and Guardian, two of the four trusts the Pension Fund then held in its portfolio. Shafiroff said, in respect of Guardian, that he felt loan loss reserves would be built up, therefore reducing the dividend, which he estimated would pay $1.05.[8]

The jury would also be obliged to find, on the basis of the uncontradicted evidence, that from January through March, 1974, adverse economic conditions affecting the REIT industry were widely publicized;[9] that as early as mid-February Shafiroff recommended to the Pension Fund representatives that they consider all their holdings in that industry;

8. This paragraph places the most favorable possible construction for plaintiffs upon Gunthorp's notes of the conversation (PX 23).

9. See n. 4 *ante;* DX D, F, G, H, I and K (pertinent articles and reports printed by the Wall Street Journal during the period January 18-March 18. 1974) ; and DX K, an article which appeared in Forbes Magazine on March 15, 1974, analyzed the REIT industry's difficulties and the more stringent attitudes of its auditors, and states:

> "The message to investors seems pretty clear: Pull out of REIT stocks at the first sign of a decline in the real estate market, because the industry and its auditors find it just too difficult to provide for hard times. Hardly, we suspect, what REIT managers want to hear, but after 1973 we worry more about underreserving than overreserving."

that the Pension Fund representatives, following the March 18 conference call, decided to dispose of all the Fund's marketable REIT shares; and that it was the Pension Fund's independent decision to sell Guardian shares first. The secondary sale, through Lehman, of 80,000 of the Pension Fund's 100,000 Guardian shares on March 20 gave rise to this litigation.

The decisive question is whether those particular facts, which arise from the most favorable view of the evidence the jury could reasonably take, establish a cause of action for plaintiffs against either defendant. I must answer that question in the negative.

First, such internal corporate information as Lehman obtained from Guardian prior to the March 20 sale falls within that area of disclosure which corporations may make to securities analysts without violating the securities laws, under the Second Circuit's holding in *S.E.C. v. Bausch & Lomb*, 565 F.2d 8 (2d Cir. 1977). Plaintiffs stress the references to an increase in Guardian's "problem loans," but the information obtained by Lehman from Guardian must be considered in its entirety; and Guardian accompanied that advice with assurances, accepted by analyst Callaghan after his further review, that none of the "problem" investments represented "any potential loss of principal." Since the function of a loan loss reserve is to guard against loss of principal, no substantial increase in the reserve (and consequent decrease in dividends) could have been foreseen on the basis of the information from Guardian reflected in Callaghan's reports of March 1 and March 14.[10] In point

10. In *Bausch & Lomb* at 14, Chief Judge Kaufman states for the Court:

> "The SEC, of course, does not maintain that the securities laws prohibit all disclosures of internal corporate information.

(footnote continued on next page)

of fact, Callaghan foresaw none: he expected the dividend to remain at $1.08 per share. Again viewing the evidence of the March 18 conference call in the light most favorable to plaintiffs, Shafiroff expected the next Guardian dividend to be $1.05. Neither Lehman representative had any advance notion that Peat, Marwick would require, on March

> The Commission itself has recognized that corporate management may reveal to securities analysts or other inquirers nonpublic information that merely fills 'interstices in analysis,' or tests 'the meaning of public information.' Matter of Investors Management Co., Securities & Exchange Act Release No. 9267 (July 29, 1971), [1970-71 Transfer Binder] FED. SEC. L. REP. ¶78,163 at 80,521 (CCH). Only when the inside information so 'leaked' is essentially 'extraordinary in nature' and 'reasonably certain to have a substantial effect on the market price of the security' if it is publicly disclosed does a duty arise to make the information generally available. SEC v. Texas Gulf Sulphur Co., supra, 401 F.2d at 848."

The Second Circuit also referred in *Bausch & Lomb*, at 14 n. 6, to an address given by Phillip A. Loomis, Jr., General Counsel of the SEC, which Judge Ward quoted in the opinion below for this Court, 420 F.Supp. 1226, 1231-2 (S.D.N.Y. 1976). Responding to questions, Mr. Loomis said:

> "MR. WRIGHT: Would it be proper for a company officer to discuss the implications on earnings of a volume of business somewhat larger than that forecast at the time of the annual meeting?
> "MR. LOOMIS: Yes, provided they don't go overboard.
> "MR. WRIGHT: How about discussing the implications on earnings of a disappointing level of business?
> "MR. LOOMIS: Surely, if they want to.
> "MR. WRIGHT: Could they properly discuss the rising cost of overhead and the increased volume needed to maintain their earnings at the level of the recent past?
> "MR. LOOMIS: I think they could, and, again, *I welcome this.*" (emphasis added). These statements reflect the conclusion of Commission and Courts alike that, particularly in times of heightened public concern and interest in a company or industry, it is "useful and appropriate" for analysts, through inquiries to management, to test the "meaning of public information." *Bausch & Lomb* at 17. The information given by Guardian to Callaghan about the current status of its "problem loans" falls within that rationale, at a time when it was common knowledge that economic conditions affecting REITs were increasing the likelihood of problem loans.

27, the establishment of a special addition for possible loan losses of $875,000, which caused the next dividend to tumble to $.74 per share.[11] When the information made available by Guardian to Lehman prior to the sale is considered in its entirety, and in the light of current REIT industry conditions well known to the public, I conclude as a matter of law that the particular omitted fact seized upon by the plaintiffs could not have been viewed by a reasonable investor "as having significantly altered the 'total mix' of information made available" through the several sources.[12]

11. The importance attached by securities analysts or other recipients to the information in question is "a factor which has long been considered a major index of materiality." *Bausch & Lomb* at 18, citing other Second Circuit authority. Thus it is significant that neither Callaghan nor Shafiroff regarded Guardian's "problem loans" data as of sufficient moment to materially affect the dividends. While Callaghan in his March 1 memorandum recognized the possibility that Guardian might "strengthen the reserve over the next few quarters and report earnings and dividends a little lower than our estimate" (see p. 7, *ante*), he testified that by the phrase "a little lower" he meant a decrease in dividends of "a few pennies to a nickel" per share. Shafiroff's estimate conforms to that relatively minor reduction. Callaghan testified that the magnitude of the dividend reduction to $.74 per share, publicly announced by Guardian on March 29, shocked and surprised him, in view of Guardian's prior advices to him.

12. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). In the case at bar, far more significant ingredients in the "total mix" than the amount of problem loans were the statement of Guardian management that they did not anticipate any loss of principal on the problem loans; and Lehman's conclusion that dividends would not be substantially affected. In these circumstances, the " 'anticipated magnitude of the event in light of the totality of the company activity' was, at best, speculative." *Harkavy v. Apparel Industries, Inc.*, 571 F.2d 737, 741-2 (2d Cir. 1978), quoting *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969). We are admonished by the Second Circuit that "not only the probability of an event but also the magnitude of its potential impact on a company's fortunes are relevant to the determination of materiality." *SEC v. Geon Industries, Inc.*, 531 F.2d 39, 47 (2d Cir. 1976), quoted in *Bausch & Lomb, supra*, at 17-18. In the "total mix" of the case at bar, the single ingredient relied upon by plaintiffs—the problem loans figure—fails as a matter of law to cause the soufflé to rise to the level of materiality. See also *Harkavy, supra.*

In consequence, there is no basis in this record upon which the jury could make a finding of materiality.

III.

Equally dispositive of the plaintiffs' claims, there is no basis in this record upon which the jury could find scienter —that is, intent to deceive, manipulate, or defraud—[13] on the part of either defendant.[14]

CONCLUSION

It follows that defendants' motions for a directed verdict must be granted.

Defendants are directed to settle a judgment on notice, dismissing the complaint with prejudice, and with costs to be taxed in their favor.

It is So Ordered.

13. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976); *Harkavy, supra; Bausch & Lomb, supra.* In the case at bar, the testimony of Lehman's representatives, Callaghan and Shafiroff, was that they did not expect what they were told about Guardian's problem loans to affect dividends substantially. See fn. 11, *ante*. Because that testimony, corroborated by the documents, is uncontradicted and unimpeached, it may be considered as evidence adverse to plaintiff, even within the context of a Rule 50(a) motion. *Lopez v. A/S D/S Svendborg*, 581 F.2d 319, 321 (2d Cir. 1978), quoting *Bigelow v. Agway, Inc.*, 506 F.2d 551, 554 (2d Cir. 1974). The reassuring conclusion drawn by Callaghan and Shafiroff with respect to dividends precludes a finding of scienter on the part of both Lehman and the Pension Fund, whose only source of information was Lehman.

14. A plaintiff's failure to prove scienter requires dismissal of a 10-b(5) complaint, quite independently of the question of materiality. *Harkavy, supra*, at 571 F.2d 742.

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

No. 1150, Docket 79-7217

Argued June 4, 1979

Decided Oct. 5, 1979

LEO and LOYCE LILLY,
Plaintiffs-Appellants,

v.

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND and LEHMAN BROTHERS INCORPORATED,
Defendants-Appellees.

Before OAKES and MESKILL, Circuit Judges, and SIFTON, District Judge.*

SIFTON, District Judge:

This appeal arises from allegations that a real estate investment trust, or REIT, with approximately $400,000,000 in assets, known as Guardian Mortgage Investors, or GMI, on the eve of the issuance of its annual audit results in the spring of 1974, disclosed to one of its principal financial advisors, Lehman Brothers Incorporated, that the REIT's "problem loans" had increased in the three months since

* Of the Eastern District of New York, sitting by designation.

its last public statement on the subject from $7,000,000 to $16,000,000 or $18,000,000. This inside information, it is alleged, was passed on by the brokerage firm to The State Teachers Retirement System of Ohio Pension Fund, another Lehman Brothers' client, which thereafter sold 80,000 shares of the REIT's stock to plaintiffs and the class they represent by means of a secondary offering, managed by Lehman Brothers, without disclosure of the inside information to the purchasers. Nine days after the secondary offering, the REIT made public information that it was substantially increasing its loss reserves and that its dividends would be substantially lower than those paid the preceding year. As a result, the stock fell precipitously and plaintiffs suffered an immediate loss on their investment.

At the conclusion of plaintiffs' case the court below dismissed plaintiffs' complaint, which alleged violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and granted motions for directed verdicts in favor of Lehman Brothers and its pension fund client. The court concluded that the jury could not rationally find that the inside information said to have been "tipped" by the REIT to Lehman Brothers and by Lehman Brothers to the pension fund was material, or that Lehman Brothers and its client acted with an intent to defraud or to deceive in selling the 80,000 shares of the REIT's stock to the uninformed public. Since our examination of the record reveals evidence on the basis of which a jury could have reasonably concluded that the "tip" was material and that the sale by the "tippees" was accomplished with knowledge of the tip's materiality and with fraudulent and deceptive intent to take advantage of the public's ignorance, we reverse in order

that the issues raised by plaintiffs' complaint may be resolved by jury.

The economic situation in the context of which this insider "tip" is said to have occurred was characterized, according to the evidence below, by rising interest rates and materials shortages. REITs, which one witness testified make money on the spread between the interest rates at which they borrow from banks and that at which they lend to real estate developers and builders, were generally perceived to be suffering as a result of increases in the prime rate from around 6% in March 1973 to around 10% in March of the following year. Real estate developers who might reasonably be expected to resist increases in borrowing costs which exceeded their expectations appeared particularly resistant to proposals by REITs to pass on to them the higher cost of money as materials shortages led to escalating costs of other supplies. These factors affecting the real estate market in general and the market for REIT stocks in particular were chronicled in detail in the financial press at the time, articles from which were made part of the record below. In the fall of 1973 and spring of 1974 these factors were generally perceived to have resulted in the well publicized failure of one prominent real estate developer and thereafter, of a prominent REIT.[1]

1. An article in the *Wall Street Journal* for January 21, 1974, entitled, "REITs Face Shake-out as Investments Sour, Cash Sources Dry Up," reads in part as follows:

> "The crux of the problem is that a growing number of the trusts' construction and mortgage loans are coming into default as builder-developers are hurt by past overbuilding, inflation, high interest costs and materials shortages."

An article in the *Wall Street Journal* for January 23, 1974, reported the cancellation of a stock offering by a major REIT. An article from

(footnote continued on next page)

In this context the expression, "problem loans," developed, according to the evidence below, as an expression of somewhat uncertain content which figured prominently in public and private evaluations of the industry and of REIT stocks. According to one witness the expression referred to a spectrum of situations running from loans to builders and developers on which the REIT had stopped accruing interest because of default in payment, to loans in default of which the REIT had taken possession of the underlying real estate or deviopment securing the loan.

The uncertainty as to the situation referred to by the expression, "problem loans," was compounded by well publicized debates within the accounting profession as to the appropriate method of treating problem loans for purposes of auditing and reporting on the financial condition of REITs. As an example, one witness below testified that according to one accounting philosophy the REIT, which

the same paper for March 1, 1974, reported a major addition to the loan loss reserve for another REIT. On March 14, 1974, under the headline, "Audits Become Painful for Some REITs That Focus on Mortgage, Building Loans," the *Wall Street Journal* reported:

> "Year-end audits are turning into an expensive nightmare for some real estate investment trusts that specialize in construction and mortgage loans.
>
> "A sudden surge in problem loans in 1973's second half, tied to sluggishness and some collapses in the construction industry, brought down some REITs earnings and presented other problems. Auditors doubled their efforts. Some asked for independent appraisals on certain properties . . . Auditors concede they have little expertise in evaluating the likelihood that a given construction job will default on payment or fall into foreclosure. That is one reason they are asking for the outside appraisals. . . . At this point most trusts with calendar years, and particularly those with substantial problem loans, haven't yet reported year-end results."

On March 18, 1974, two days before the sale here at issue, the *Wall Street Journal* reported the filing of a Chapter XI proceeding by a prominent REIT.

upon default protected itself by foreclosing on its real estate security, should be treated as itself a developer and its actual and anticipated losses calculated according to auditing procedures and accounting standards appropriate to that business. According to another philosophy, however, the REIT in such a situation should continue to be regarded as simply a real estate investment vehicle, fully protected against loss on its investment as long as it appeared that on the ultimate realization of the development's expectations, the REIT would suffer no loss on the principal of its loan.

The reason for this lively investor interest in the subject of problem loans and for the coverage in the financial press of differences within the accounting profession in dealing with them was, the jury could have concluded, because of the uncertainty in the minds of the accounting profession as to the appropriate relationship between problem loans and loss reserves and because of the key role played by loss reserves in the evaluation of REIT stocks as investments. While the relationship of an REIT's problem loans to its loss reserves was uncertain and subject to considerable debate, changes in loss reserves were related in a devastatingly simple, almost mechanical way to the price of the REIT's stock. The explanation of this relationship lay in the structure and operation of REITs as dictated by the Internal Revenue Code.

As witnesses testified below, any increase in an REIT's loss reserves could only be established by a corresponding charge to current earnings; REIT earnings were, in turn, related to the REIT's dividends by the requirements of the Internal Revenue Code. In order to qualify as an REIT under the Code, thereby avoiding treatment of its revenues

as income for tax purposes, the investment trust was required, *inter alia,* to distribute at least 90% of its otherwise taxable income as dividends. 26 U.S.C. §§ 856-58 (1970) (amended 1976). Moreover, in order to avoid second guessing by the Internal Revenue Service with regard to revenues properly included on its calculation of otherwise taxable income, most REITs, including GMI, made it a practice to distribute dividends equal to their annual revenues. Finally, because REIT stocks were looked to in the investment community primarily for income rather than for gains resulting from capital accretion, the prices of REIT stocks were exceptionally sensitive to changes in dividend levels.

Given this structural sensitivity of the price of an REIT's stock to the level of loss reserves deemed by the REIT and its accountants to be appropriate in the light of its problem loans, it is understandable why at the particular period of time here at issue extraordinary attention was focused by investors on the uncertain subject of problem loans. As one witness testified:

> "Problem loans is a designation that began around that time. But at the time beginning around then and in subsequent months, problem loans became the heavy focus of everyone in the securities industry in analyzing the financial condition of an REIT, and problem loans became a normal part of any conversation that you have.'"[2] (J.A. 343.)

In this context, it seems clear that there was substantial basis in the record for submitting to the jury the question whether information concerning the level and the trend

2. One witness from the REIT testified that all of the analysts calling GMI at that particular time inquired about the level of problem loans (Joint Appendix [J.A.] 273). The witness testified that to all questions "our response during that period of time was the fact that we were not giving a response." (J.A. 271.)

pursued by GMI's problem loans was the kind of information which a reasonable investor would want to know before deciding whether to purchase the REIT's stock,[3] and, in particular, whether information, that the level of problem loans as calculated by management had increased from $7,000,000 to $16,000,000 or $18,000,000 over a three-month period, would be regarded by a reasonable investor "as having significantly altered the 'total mix' of information . . . available" concerning the REIT's financial condition. *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449, 96 S.Ct. 2126, 2132, 48 L.Ed. 2d 757 (1976).

Indeed, the manner in which the information was regarded by those privy to it and the importance attached to the information by the recipients after the "tip" could be found to have been given, *cf. S.E.C. v. Bausch & Lomb, Inc.*, 565 F.2d 8, 18 (2d Cir. 1977), were entirely consistent with a conclusion that the information was material information. The President of GMI, whose deposition was read at trial, himself treated the information as material inside information, testifying that he had declined to furnish a Lehman Brothers' research analyst with the information because it was not publicly available.[4] Almost immediately following

3. As grim as were the problems faced by "some REITs," according to the financial press, the identification of the particular REITs, suffering from these problems was still open to question and, the jury could have inferred based on the sales here at issue, continued to be a subject of investor interest.

4. The President of the REIT testified:

"Q: Do you recall what you told Mr. Callaghan about the answer to his inquiries about the level of the problem loans?
"A: Well, any specific data was declined in terms of what was not already released and in the hands of the public.
"If it was there, we would certainly be free to discuss it. But at that point, the last communique that anyone in the public

(footnote continued on next page)

the receipt by Lehman Brothers of the information concerning the level of the REIT's problem loans, the Lehman Brothers' analyst receiving the information prepared a "Research Wire" labeled, "Not for distribution outside of Lehman Brothers," devoted exclusively to reporting the information received and to an analysis of its significance in terms of the REIT's loss reserves, earnings and anticipated dividend levels. A second contact by the research analyst with another representative of GMI a week later, which, the jury could have found, produced additional information concerning the REIT's problem loans, was recorded by the analyst in an "REIT contact report." According to the testimony, this report, which on its face indicated that GMI management was the source of the information discussed, was circulated to customers of Lehman Brothers including, the jury could infer, the defendant pension fund. Again, the report explicitly analyzed the effect of the information with regard to problem loans on the REIT's anticipated earnings and dividend levels noting that "*audited* earnings for the fiscal year ended February 28, 1974 are expected to be reported between 3/22/74 and 3/27/74." (Emphasis in original.)

Despite the obvious importance attributed to the information concerning the increase in GMI's problem loans by both GMI and Lehman Brothers, the court below concluded that the jury could not rationally find that the information was material. A principal basis for this conclusion appears

markets would have received would have been the December press release, I assume . . . .

"And on the basis of that and prior releases to that, or quarterly statements, we could be free to talk. But certainly anything subsequent to that, our reply was that none of the operations nor any of the other figures could be available until the completion of the audit." (J.A. 344-45.)

to have been the fact that, according to Lehman Brothers' memoranda introduced during the plaintiffs' case, it was the view, first expressed by the brokerage firm as that of the brokerage firm itself arrived at after discussions with management and later simply as that of management, that no loss of principal was anticipated on any of the REIT's problem loans. Given this conclusion, the court below reasoned, no increase in loss reserve to guard against loss of principal was necessary and no decrease in dividends could be foreseen. Since no substantial change in the dividend level was anticipated, the inside information was not "reasonably certain to have a substantial effect on the market price of the security," a test of materiality taken by the court below from *S.E.C. v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. S.E.C.*, 394 U.S. 976, 89 S.Ct. 1454, 22 L.Ed.2d 756 (1969), and the "anticipated magnitude of the event in the light of the totality of the company activity was, at best, speculative," a test taken from *Harkavy v. Apparel Industries, Inc.*, 571 F.2d 737, 741-42 (2d Cir. 1978). Accordingly, the court below concluded, the information alleged to have been obtained by Lehman Brothers from the REIT was not the type of information in which a reasonable investor would be interested.

The error in this reasoning is that it assumes a clear-cut and well-defined relationship between problem loans and loss reserves which the jury could have concluded on the evidence below did not exist in the minds of investors at the time here at issue. Given the evidence introduced below including articles from the financial press detailing the substantial uncertainty both among laymen and professional accountants concerning the definition of problem loans, their treatment for accounting purposes in general,

and their relationship to loss reserves in particular,[5] it was error for the court to conclude as a matter of law that investor interest in the increase in GMI's problem loans would have disappeared given a simple assurance from management that no principal loss was anticipated on any particular problem loan.[6] That information, the jury could

5. One witness, a former Lehman Brothers' employee, testified:

> "Q. Now, back in March of 1974, did analysts like yourself who followed REITs recognize a relationship between problem loans and the loan loss reserve?
> "A. Yes.
> "Q. Can you tell us as best you can recall what that relationship was?
> "A. No, because at that time there was no consistent pattern in developing loan loss reserves within the industry." (J.A. 502.)
>
> * * * * * *
>
> ". . . there was no formula, as best I can remember, in determining this. It was more subjective than objective."
> "Q. Back in March of 1974, was it your understanding that if problem loans would go up the loan loss reserve would go up?"
> "A. Yes." (J.A. 505.)

The witness hardly clarified the situation by testifying on cross-examination in response to questions by an attorney for Lehman Brothers as follows:

> "Q. Let me try it this way, Mr. Callaghan: If a loan, if a party anticipates no loss of principal on a loan, in your opinion would that affect the allowance for loan loss reserve?
> "A. Under the theory of loss reserving, it would not. Under the practice of loss reserving, it would." (J.A. 529-30.)

6. Loss reserves, the jury could have concluded, serve not only the purpose of making provision against losses actually anticipated with regard to particular loans, but also the purpose of making provision against the increased risks of unanticipated losses resulting from changes in the volume or size of the business or, as in this case, changes in the number of loans in default. Thus, in the *Forbes Magazine* article, referred to in footnote 10 below, results of a survey of industry practices were set forth in which only 11% of the 84 REITs queried reported that they calculated the appropriate loss reserve on the basis of known losses. 41% based the calculation of the appropriate loss reserves on a percentage of net income. 24% were reported to have

(footnote continued on next page)

have found, did not eliminate a risk the magnitude of which could not have been predicted with any reasonable degree of certainty that the increase in the REIT's problem loans would significantly affect the REIT's financial condition. The reasonable investor has an interest in knowing not only information which will, with reasonable certainty, affect the price of the stock he contemplates buying or selling. He also has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty and turns an otherwise reasonable investment into a speculative one.

A further difficulty presented by the trial court's reasoning is that it analyzes the significance of the information alleged to have been tipped not from the standpoint of the reasonable investor at all, but rather from the standpoint of the tippee, focusing on the significance attributed to the information by its recipient. There is no basis for such an approach in our cases. On the contrary, the standard of materiality requires that efforts be made to place the in-

used a percentage of the investment portfolio. The article continues by stating:

> "But, . . . little logic can be found for choosing any one of these approaches. There ought to be firm guidelines, we [the authors of the article] said. Again, we heard a litany of the difficulties involved. Since the industry is so young, there is little history to go by. What sense does it make to take a percentage of income when any number of variables can affect how much will be recovered? Normally, a trust can get all or most of its money out of a foreclosure, but what if it cannot? How can you reserve for a total loss on one loan in a portfolio of 16 or 17 mortgages?"

In this situation a substantial increase in an REIT's problem loans, which on its face substantially increased the risks of unanticipated losses, placed the REIT at the center of a lively debate within the accounting profession as to the appropriate loss reserve to be established. In the circumstances, the jury could well have concluded that the effect of the substantial increase in the REIT's problem loan was to make it impossible to assess with any reasonable degree of certainty how the accountants would report the REIT's financial condition.

vestor in the same position as the tippee with regard to available information in order that the investor may, if so inclined, make inquiry and satisfy himself as to whether the investment he is contemplating should be made or not.[7] While in many cases the private evaluation of inside information by a tippee will coincide with the significance attributed to the information by a reasonable investor, it is precisely in a situation in which the public reaction to release of the information cannot be predicted with any reasonable degree of certainty that the insider's personal evaluation of the information becomes largely irrelevant to an assessment of its materiality.

Evidence as to Lehman Brothers' own efforts to evaluate the significance of the information it received and to quantify its effect on GMI's earnings and dividends does, however, have obvious, although not dispositive relevance to the issue of its intent in urging the sale of GMI stocks by its pension fund client. It remains, therefore, to consider whether there existed evidence sufficient to warrant submission of the case to the jury on this issue. Our examination of the record reveals quite traditional bases from which the jury could have reasonably inferred an intent to deceive as an animating force behind the sale made by the pension fund on March 20, 1974—just two days prior to the earliest date on which Lehman Brothers anticipated release of the RIET's financial statements.

7. On the evidence below there was at least a strong possibility that inquiry by a putative investor would have resulted in a conclusion that principal losses could be anticipated with regard to some of GMI's problem loans. Indeed, the audit team from Peat, Marwick, Mitchell & Co. engaged in preparation of the REIT's annual report arrived at that conclusion, precipitating a confrontation with management as to the appropriate loss reserve philosophy to be followed and loss reserve to be established which led to a sizeable increase in GMI's loss reserves and consequent decrease in dividends and fall in the price of its stock.

First, the President of the REIT, the Lehman Brothers' analyst principally responsible for the decision by the pension fund to sell the REIT's stock, and the officer of the pension fund who made the decision to sell, all denied that they had been party to a disclosure of information concerning an increase in the level of problem loans at the REIT prior to the sale. The testimony of the President of the REIT was that, while such information was undoubtedly of the type which should not be disclosed, he had not made any such disclosure (J.A. 344-45). This testimony, the jury could have found, was contradicted by internal Lehman Brothers' memoranda which recorded a contact by a Lehman Brothers' research analyst with the REIT's President and the report of the information by the same analyst as contemporaneous events.[8] The testimony of the Lehman Brothers' broker principally responsible for the sale of the stock was that he had not been aware of the level of the REIT's problem loans prior to March 29, 1979, after the sale here at issue had occurred (J.A. 626). This denial was also subject to question by the jury in the light of the internal Lehman Brothers' Research Wire entirely devoted to a discussion of GMI's increased problem loans circulated within Lehman Brothers at a time when the pension fund's sale of its holdings of GMI stock was under active consideration. The testimony by the pension fund officer responsible for deciding to make the sale of GMI was that he had never discussed the merits or demerits of a particular REIT

8. A mimeographed form used by Lehman Brothers to record "Management Contacts" signed by the analyst beneath the statement, "On the basis of these discussions, no information of a material inside nature evolved, in my best judgment" refers to a contact with the President of GMI occurring on March 1, 1974. The Research Wire is also dated March 1, 1974, a Friday, with a parenthetical dateline "Released Monday Morning—March 4."

stock with Lehman Brothers' representatives, but that all discussions had dealt exclusively with "generalities about the REIT industry as a whole." (J.A. 115, 127). This testimony was subject to considerable question by the jury in the light of the description by another pension fund employee of two telephone calls between both pension fund representatives and two Lehman Brothers' research analysts on the eve of the sale during which the merits of the particular REIT stocks in the pension fund portfolio were discussed in what the jury could have inferred was some detail (J.A. 433, 449).

While the District Court apparently had issues of credibility such as these in mind in passing on defendants' motions for directed verdicts, it found no basis for permitting the jury to resolve these issues, apparently on the theory that the jury could not conclude that the defendants' state of mind was different than it was stated to be without violating the teaching of *Dyer v. MacDougall,* 201 F.2d 265 (2d Cir. 1952), that a plaintiff's case cannot rest simply on the disbelief of the plaintiff's witnesses. There are two grounds for rejecting this reasoning. First, lack of credibility was not the only basis on which to infer an intent to deceive or defraud in the evidence below. Secondly, the issue presented by this question of credibility was not as to what the witnesses would have said, if they testified truthfully—a piece of jury speculation condemned in *Dyer v. MacDougall, supra.* Rather, the jury was in a position to be asked to draw rational inferences as to the unstated reasons why the witnesses would not tell the truth under these circumstances: that the REIT's President, the Lehman Brothers' analyst, and the pension fund personnel all denied that the tip had occurred because of an awareness

that, if the jury believed the disclosure occurred, the witnesses would be unable to withstand cross-examination and jury scrutiny of their motives and intentions.

Beyond these arguably false exculpatory statements from which the jury could rationally infer an intent to deceive, other evidence existed in the record bearing on the defendants' state of mind. Plaintiffs presented evidence concerning Lehman Brothers' careful instruction and training of its analysts with respect to the receipt and use of material inside information. There was also evidence that the particular Lehman Brothers' analyst who, the jury could have found, received the tip had his attention focused on the question of whether the information received could be properly circulated since he was required to execute a Lehman Brothers' form stating that, although he had just had contact with a corporate insider, no material information had been received. With regard to the state of mind of the pension fund representatives, the evidence presented would have warranted a jury's finding that the decision to sell the GMI stock had been made despite advice by two other brokers that another REIT stock in the portfolio was more appropriate for sale first. While it might be a permissible inference that other arguments advanced by Lehman Brothers persuaded the pension fund to act contrary to the advice of the other brokerage houses, it was also a permissible inference that the reason for the sale of the GMI stock was to take advantage of the inside information supplied by Lehman Brothers with regard to the undisclosed increase in problem loans by an immediate sale in advance of the imminently expected release of GMI's annual report. Circumstantial evidence concerning the speed and somewhat unusual mechanics by which the secondary

offering was accomplished provided plaintiffs with a rational argument that there was, on the part of both Lehman Brothers and the pension fund, a desire for haste consistent with an intent to get the stock into the hands of the public before the release of the audit report in which the trend of the REIT's problem loans would be revealed. Evidence with regard to the nature of the relationship between Lehman Brothers and the REIT on the one hand, and between Lehman Brothers and the pension fund on the other, gave the plaintiffs some circumstantial support with regard to the motivations of the parties.

Countering these considerations was the evidence already noted on the basis of which the jury could have inferred that Lehman Brothers, after examining the information concerning the increase in GMI's problem loans, concluded that it had no significance. This information included not only the proof that the Lehman Brothers' analyst who received the information, after discussing the matter with management, recorded himself as satisfied that no principal loss was anticipated, but also evidence that Lehman Brothers worked out the increase to reserves, decrease in revenues and change in dividends which could be anticipated in the face of the increase in problem loans, and concluded that those reserves, earnings and dividends would show changes from those reported in the past which were not significant in light of the problems of the industry in general.[9] Defendants were certainly in a position to argue

9. Although no explanation of the calculation is apparent from the record, the Lehman Brothers analyst who, the jury could have found, received the tip concerning GMI's increased problem loans on March 1, 1974, reported in the internal Research Wire circulated on March 4, 1974:

> "Because of the current level of problem loans, we are lowering our earnings estimate for the quarter ending February 28, 1974

(footnote continued on next page)

forcefully to a jury that, if they believed that the anticipated lower dividends levels, despite the increase in problem loans, were no different from what anyone would have anticipated at the time even without knowing the level of the REIT's problem loans, then defendants should not be found to have had an intent to mislead anyone by selling to a public unaware of the increase in problem loans.

Nevertheless, rational answers to this contention could be inferred from the evidence and were deserving of evaluation by a jury. Given the well publicized debate concerning the conflicting methods of treating problem loans, Lehman Brothers' expressed confidence that no principal loss could be anticipated with regard to any particular loan did not rationally exclude the existence of an awareness on the part of Lehman Brothers that the effect of the increase in problem loans on the REIT's loss reserves and dividends could not be predicted with any certainty.[10] Nor, the jury

---

to approximately $1.10, as compared with the November 1973 quarterly earnings of $1.14 and the $1.07 earned a year ago for the quarter ended 2/28/73. We expect this quarter's dividend to be about the same as last quarter's $1.08.

"The trust's loss reserve as of November 30, 1974 amounted to $1.4 million or 0.4% funded investments. It would not totally surprise us if the trust were to strengthen the reserve over the next few quarters and report earnings and dividends a little lower than our estimates."

10. It is significant in this connection that the entire contents of a two-page article in the issue of *Forbes Magazine* dated March 15, 1974, entitled, "When is a Lemon a Lemon?" was, according to one witness, read over the telephone to the pension fund personnel responsible for deciding whether and when to sell the fund's portfolio of REITs during the course of a telephone discussion with Lehman Brothers' personnel of the advisability of selling the stocks (J.A. 622). As noted in note 6, *supra*, a substantial part of the article was devoted to differences within the accounting profession concerning the auditing and reporting standards appropriate in dealing with REIT problem loans and establishing loss reserves.

could have found in the absence of some evidence as to what Lehman Brothers did to investigate the likelihood of principal loss, could Lehman Brothers be, to any reasonable degree, certain in the circumstances that others, including the REIT's auditors, would arrive at the same conclusion which it arrived at with regard to the likelihood of principal loss after review of the increase in problem loans. The evidence with regard to Lehman Brothers' calculations of the anticipated dividend level is more enigmatic. However, being enigmatic, it hardly dictated the conclusion that the only rational result which the jury could arrive at was that the defendants acted without intent to deceive. Taken together with defendant's denial that the information was, in fact, "tipped", it was a permissible inference that the defendant's interpretation on paper of the adverse inside information received was recognized to be only a partial statement of the significance of the information leaving out of account what could not be accounted for with any reasonable certainty—namely, the public's and accounting profession's reaction to disclosure of the information. This interpretation of the record gains some support from consideration of the peculiarly ironic tone of the internal Lehman Brothers' memorandum in which Lehman Brothers' estimate as to future dividends is set forth for the first time. After discussing the size of the problem loans, the anticipated changes in earnings and dividends, and the size of the trust's loss reserve, the memorandum concludes:

> "It would not totally surprise us if the trust were to strengthen the reserves over the next few quarters and

report earnings and dividends a little lower than our estimates.'"[11]

The significance of the issues raised by the evidence with regard to defendants' state of mind was for the jury to determine. The judgment dismissing plaintiffs' complaint and granting defendants' motions for directed verdicts is, accordingly, vacated, and the case is remanded for a new trial.

11. The writer's use of the word "little" in the quoted paragraph could well have been compared by the jury with his use of the word "slightly" in the letter to the S.E.C. in which he described the inside information received as follows:

> "They [GMI personnel] advised me that GMI's problem loans had increased slightly from the end of the prior quarter and that they are currently running about 4% of funded investments."

At no place in this letter to the S.E.C. was it indicated that the slight increase was from $7 million to $18 million.

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the fifth day of October, one thousand nine hundred and seventy-nine.

Present:

HON. JAMES L. OAKES
Circuit Judge
HON. THOMAS J. MESKILL
Circuit Judge
HON. CHARLES P. SIFTON
District Judge

79-7217

LEO and LOYCE LILLY,
Plaintiffs-Appellants,

v.

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND and LEHMAN BROTHERS INCORPORATED,
Defendants-Appellees.

Appeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

On Consideration Whereof, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is reversed and the action be and it hereby is remanded to said district court for further proceedings in accordance with the opinion of this court with costs to be taxed against the appellees.

A. Daniel Fusaro,
Clerk

Arthur Heller
By: Arthur Heller,
Deputy Clerk

Orders of the Court of Appeals Denying Petitions for Rehearing

UNITED STATES COURT OF APPEALS

Second Circuit

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the Twenty-first day of December, one thousand nine hundred and seventy-nine.

79-7217

Leo and Loyce Lilly,
Plaintiffs-Appellants,

v.

The State Teachers Retirement System of Ohio Pension Fund and Lehman Brothers Incorporated,
Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellee Lehman Brothers Incorporated and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is Ordered that said petition be and it hereby is Denied.

Irving R. Kaufman
Chief Judge
Irving R. Kaufman

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the Twenty-first day of December, one thousand nine hundred and seventy-nine.

79-7217

LEO and LOYCE LILLY,
Plaintiffs-Appellants,

v.

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND and LEHMAN BROTHERS INCORPORATED,
Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellee The State Teachers Retirement System of Ohio Pension Fund and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is Ordered that said petition be and it hereby is DENIED.

IRVING R. KAUFMAN

Chief Judge
Irving R. Kaufman

Supreme Court, U.S.
FILED
APR 21 1980
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

79-
Nos. 1470 and 1471

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND

and

LEHMAN BROTHERS, INC.,

Petitioners,

against

LEO and LOYCE LILLY, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS LEO AND LOYCE LILLY IN OPPOSITION

RONALD LITOWITZ
EDWARD A. GROSSMANN
Counsel for Respondents Leo and Loyce Lilly
KREINDLER & KREINDLER
99 Park Avenue
New York, New York 10016
(212) 687-8181

TABLE OF CONTENTS

	PAGE
Opinions Below	1
Jurisdiction	2
Statutes and Regulations Involved	2
Statement of the Case	2
Argument	4
I. The Court Below Properly Applied The Decision Of This Court In *TSC Industries, Inc.* v. *Northway, Inc.*	5
II. The Court Properly Considered Lehman's Reaction To The Tip	8
III. There Is No Conflict In The Circuits	9
Conclusion	10

Table of Authorities

Cases:

Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972)	5
Chasins v. *Smith Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970)	9
Hidell v. *International Diversified Investments*, 520 F.2d 529 (7th Cir. 1975)	9
Kohler v. *Kohler & Co.*, 319 F.2d 634 (7th Cir. 1963)	9
Myzel v. *Fields*, 386 F.2d 718 (8th Cir. 1967)	9
S.D. Cohn & Co. v. *Woolf*, 426 U.S. 944 (1976)	10

PAGE

Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977) 10

SEC v. *Shapiro*, 494 F.2d 1301 (2d Cir. 1974) 9

Sonesta International Hotels Corp. v. *Wellington Associates*, 483 F.2d 247 (2d Cir. 1973) 9

TSC Industries, Inc. v. *Northway, Inc.*, 426 U.S. 438 (1976) 4, 5, 6, 7, 9

Statutes and Rules:

Fed. R. Civ P. 50(a) 2, 3

17 C.F.R. § 240.10b-5 .....2, 3, 9

15 U.S.C. § 78j(b) 3

15 U.S.C. § 78n(a) 9

IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

Nos. 1470 and 1471

THE STATE TEACHERS RETIREMENT SYSTEM OF OHIO PENSION FUND

and

LEHMAN BROTHERS, INC.,

Petitioners,

against

LEO and LOYCE LILLY, *et al.*,

Respondents.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS LEO AND LOYCE LILLY IN OPPOSITION

Opinions Below

The relevant opinions below are the opinions of the Court of Appeals for the Second Circuit reported at 608 F.2d 55 (also annexed to Lehman Petition at 14a) and that of the Southern District of New York reported at CCH Fed. Sec. Law Rptr. ¶ 96,769 (annexed to Lehman Petition at 1a).

Jurisdiction

The jurisdictional requisites are adequately set forth in the petitions.

Statutes and Regulations Involved

15 U.S.C. § 78j(b). [§ 10(b) of the Securities Exchange Act of 1934].

17 C.F.R. § 240.10b-5. [Rule 10b-5 promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934].

Statement of the Case

This is a class action on behalf of all persons who were purchasers from The State Teachers Retirement System of Ohio Pension Fund ("Ohio") of any of the 80,000 shares of Guardian Mortgage Investors ("Guardian") common stock sold by Ohio in a secondary distribution (the "Secondary") through Lehman Brothers, Inc. ("Lehman") on or about March 20, 1974. The claim is that Lehman and Ohio violated Rule 10b-5 by structuring the Secondary with the advantage of non-public information which, when disclosed nine days after the Secondary, caused the market price of the Guardian shares to drop precipitously.

The case was succinctly described in the opinion of the Court of Appeals for the Second Circuit, reversing the decision of the district court granting defendants' motions for a directed verdict under Rule 50(a) F.R. Civ. P., as follows:

> "This appeal arises from allegations that a real estate investment trust, or REIT, with approximately $400,000,000 in assets, known as Guardian Mortgage Investors, or GMI, on the eve of the issuance of its annual audit results in the Spring of 1974, disclosed to

one of its principal financial advisors, Lehman Brothers Incorporated, that the REIT's 'problem loans' had increased in the three months since its last public statement on the subject from $7,000,000 to $16,000,000 or $18,000,000. This inside information, it is alleged, was passed on by the brokerage firm to The State Teachers Retirement System of Ohio Pension Fund, another Lehman Brothers' client, which thereafter sold 80,000 shares of the REIT's stock to plaintiffs and the class they represent by means of a secondary offering, managed by Lehman Brothers, without disclosure of the inside information to the purchasers. Nine days after the secondary offering, the REIT made public information that it was substantially increasing its loss reserves and that its dividends would be substantially lower than those paid the preceding year. As a result, the stock fell precipitously and plaintiffs suffered an immediate loss on their investment.

At the conclusion of plaintiffs' case the court below dismissed plaintiffs' complaint, which alleged violations of § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5, 17 C.F.R. § 240.10b-5, thereunder, and granted motions for directed verdicts in favor of Lehman Brothers and its pension fund client. The court concluded that the jury could not rationally find that the inside information said to have been 'tipped' by the REIT to Lehman Brothers and by Lehman Brothers to the pension fund was material, or that Lehman Brothers and its client acted with an intent to defraud or to deceive in selling the 80,000 shares of the REIT's stock to the uninformed public. Since our examination of the record reveals evidence on the basis of which a jury could have reasonably concluded that the *'tip'* was material and that the sale by the 'tippees' was accomplished with knowledge of the tip's materiality and with fraudulent and deceptive intent to take advantage of the public's ignorance, we

reverse in order that the issues raised by plaintiffs' complaint may be resolved by jury." (Opinion, Lehman petition, pp. 14a-16a).

As stated, the Court of Appeals reversed and remanded the action to the district court for a new trial.

Argument

It is important to emphasize the context in which the case comes to this Court. The class action claim was tried to a jury. Plaintiffs' sole evidence was documents and testimony of defendants, or those aligned with them. The evidence clearly established a "tip" of non-public information from Guardian to Lehman, but much of plaintiffs' theory of liability against Ohio related to inferences to be drawn from direct evidence and circumstantial evidence. The trial court directed a verdict for both defendants. The Second Circuit remanded for a new trial.

In reversing and remanding the Court of Appeals cited, quoted and clearly applied the test established by this Court in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976) on the issue of materiality, the key issue on appeal. The Court, in applying the *TSC* test concluded it was "error for the court to conclude as a matter of law that investor interest in the increase in GMI's problem loans [from $7 million to $16-18 million] would have disappeared . . ." (Opinion, Lehman petition, p. 23a). We respectfully submit the Court of Appeals was correct in the decision it reached. Furthermore, as spelled out below there are no significant policy issues warranting review by this Court.

POINT I

The Court below properly applied the decision of this Court in *TSC Industries, Inc.* v. *Northway, Inc.*

Both petitioners recognize that the critical question on appeal was the application of the standard of materiality for the non-public information Lehman obtained before doing the Secondary for Ohio. Both petitioners recognize, as they must, the standard for materiality in the context of a disclosure case arising under the federal securities laws is governed by this Court's decision in *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438 (1976). Lehman in its petition (p. 8) quotes the following from *TSC Industries* (p. 449) as the true test of materiality:

> "a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of the information made available."

This test has three critical elements. First, a "*would have* assumed" or "*would have* been viewed" approach is taken. This is to be contrasted with a lower standard using "*could have*" or "*might have*" which this Court used in an earlier decision in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972).

Second, an objective standard is used by referring to the "reasonable investor."

Third, the disclosure in issue is considered in the context of significantly altering the "total mix" of information available.

The Court below in making its analysis of materiality stated (Opinion, Lehman petition, pp. 19a-20a):

> "In this context, it seems clear that there was substantial basis in the record for submitting to the jury the question whether information concerning the level and the trend pursued by GMI's problem loans was the kind of information which a reasonable investor would want to know before deciding whether to purchase the REIT's stock, and, in particular, whether information, that the level of problem loans as calculated by management had increased from $7,000,000 to $16,000,000 or $18,000,000 over a three-month period, would be regarded by a reasonable investor 'as having significantly altered the "total mix" of information . . . available' concerning the REIT's financial condition. *TSC Industries, Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449, S.Ct. 2126, 2132, 48 L.Ed.2d 757 (1976)."

Thus, the Court specifically cited *TSC Industries,* and the "would" test (as opposed to "could", "might" or some other), specifically referred to the "reasonable investor": and specifically referred to the impact of the Guardian problem loan information in the context of the "total mix" of information available. Accordingly, the Court below meticulously applied the appropriate standard.

Both petitioners, however, assert the standard for materiality was indeed lowered by the Second Circuit, despite its apparent homage to *TSC Industries.* Both petitioners argue this by seizing on the Court's words:

> "He [reasonable investor] also has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty . . ." (see Lehman petition, pp. 10-11 and Ohio petition, pp. 9-11).

Both, in effect, argue that the quoted portion requires potential disclosure of great amounts of necessarily un-

informative information and by so doing the Court thereby diluted and distorted the *TSC Industries* test it purported to apply. Petitioners, unfortunately, distort the Court's thought by excising from the partially quoted sentence the following:

> ". . . and turns an otherwise reasonable investment into a speculative one." (Opinion, Lehman petition, p. 24a).

The full sentence as written by the Court is:

> "He [i.e. a reasonable investor] has an interest in obtaining information which renders it impossible to assess the value of his investment with any reasonable certainty *and turns an otherwise reasonable investment into a speculative one.*" (Emphasis supplied).

The excised portion is crucial. All investments are not of equal risk or stability. REIT stocks, such as Guardian, were considered stable income producing securities. The REITs, including Guardian, until March 1974, essentially had a record of steadily increasing quarterly income and dividend increases. Guardian specifically, since its formation in 1970, had an impressive record of successive quarterly income and dividend increases, except for one quarter in 1973.* Once this record or pattern was threatened, the source and likelihood of change was information of the utmost interest to any reasonable investor. This is both obvious and logical and, by so stating, the Court of Appeals did not depart from the *TSC Industries* test of materiality which it quoted and applied.

---

* Guardian's growth record was established at trial and emphasized in the brief on appeal.

POINT II

The Court properly considered Lehman's reaction to the tip.

Lehman makes the argument that the Court below considered the Lehman reaction to the non-public information it received as "not important" in resolving the issue of materiality. (Lehman petition, pp. 12-14).

The reaction by Lehman, asserted by plaintiffs and the class and clearly recognized by the Court, was the action taken to induce Ohio to sell its Guardian shares, sell them as quickly as possible, and to sell them at an immediate discount of $1.75 per share on the Secondary as contrasted with $.35 per share charge if the shares were sold over whatever period necessary on the New York Stock Exchange where they were listed.

The Court below specifically stated (Opinion, Lehman petition, p. 20a):

> "Indeed, the manner in which the information was regarded by those privy to it and the importance attached to the information by the recipients after the 'tip' could be found to have been given, cf. S.E.C. v. Bausch & Lomb, Inc., 565 F.2d 8, 18 (2d Cir. 1977), were entirely consistent with a conclusion that the information was material information."

The Court thereafter specifically addressed the reaction of the trial witnesses, including Lehman employees, by analyzing their actions subsequent to the receipt of the tip. The Court specifically discussed, among other factors, the manner in which Lehman prepared an internal memorandum labeled "Not For Distribution Outside of Lehman Brothers." (Opinion, Lehman petition, p. 21a). At best Lehman's argument on this point, really does no more than raise the question of whether the Court meant what it said, a very dubious basis for requesting review by this Court.

POINT III

There is no conflict in the Circuits.

Ohio asserts that a conflict exists among the Circuits and within the Second Circuit itself as to the test of materiality. Ohio recognizes the appropriateness of *TSC Industries* test using whether a "reasonable man would attach importance to the information in making an investment decision." (Ohio petition, pp. 12-16). In discussing the conflict, Ohio cites the following six cases (and only these six cases) as potentially in conflict with the *TSC* test.

Chasins v. *Smith Barney & Co.,* 438 F.2d 1167, 1171 (2d Cir. 1970); *SEC* v. *Shapiro,* 494 F.2d 1301 (2d Cir. 1974); *Sonesta International Hotels Corp.* v. *Wellington Associates,* 483 F.2d 247 (2d Cir. 1973); *Kohler* v. *Kohler & Co.,* 319 F.2d 634, 642 (7th Cir. 1963); *Myzel* v. *Fields,* 386 F.2d 718, 734 (8th Cir. 1967); *Hidell* v. *International Diversified Investments,* 520 F.2d 529 (7th Cir. 1975).

It is more than significant to note that all six decisions predate 1976, the date of the *TSC Industries* decision. While as a purely technical matter a conflict may exist between the test of materiality used in these six decisions and that applied in *TSC,* it is highly unlikely that panels of the Second, Seventh or Eighth Circuits would follow their own earlier decision and ignore the Supreme Court *TSC* decision. Accordingly, no present conflict exists which warrants resolution by this Court.

Finally, Ohio argues that review by this Court is warranted since *TSC Industries* applies to Section 14(a) of the Securities Exchange Act, 15 U.S.C. § 78n(a), and not the much litigated Section 10(b) and Rule 10b-5 under which this case arises. (Ohio petition, p. 16). The answer to this is, as co-petitioner Lehman readily recognizes, that this Court has made plain that *TSC* does apply to 10(b)

actions in *S. D. Cohn & Co.* v. *Woolf*, 426 U.S. 944 (1976) and *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) at 474 n.14.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the petitions for a writ of certiorari should be denied.

Respectfully submitted,

RONALD LITOWITZ
EDWARD A. GROSSMANN
KREINDLER & KREINDLER
Attorneys for Respondents
99 Park Avenue
New York, New York 10016
(212) 687-8181

see

7 9

1 4 7 1